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REDAZIONE:
Dipartimento di Economia
Università degli Studi Roma Tre
Via Ostiense, 139 - 00154 Roma
Tel. 0039-6-57374003 fax 0039-6-57374093
E-mail: dip_eco@uniroma3.it

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Pasquale Tridico**

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Abstract. *Transition economies (i.e. Central Eastern Europe Countries and Former Soviet Union Republics) have undergone an enormous transformation since 1989-1991. After the recession of the early 1990's, some of these economies experienced a GDP recovery, at a different pace, with different outcomes in terms of economic growth and social performance (i.e. human development, employment, poverty, etc). The aim of this paper is to answer the following research question: was human development concurrent with economic growth during transition towards the market economy? I claim that economic growth is not always concurrent with human development: economic growth can contribute to increase the level of human development, but is not "the means" to human development. The income is not the final aim. On the contrary, the final aim is the well-being of individuals and the human development. Human development is considered to be a process which allows for an environment where people enjoy long, healthy and creative lives (as defined by the United Nations Development Programme, UNDP). Using an OLS model, human development variables were correlated with GDP per capita. I found out that, in transition economies, investing in human development is a sufficient, yet not a necessary condition for economic growth. GDP growth, then, requires human development. In this context institutions and institutional policies are crucial for a development process. In fact, for better distribution and access to resources as well as for social cohesion, well-designed institutions are needed.*

Key words: Transition, Development, Institutions

1. Introduction

Many economists agree that institutional transformation lies at the heart of Post-Communist Transition. However, different conceptions of *institution* create different interpretations of that transformation. After the fall of Berlin wall in 1989, Central and Eastern European Countries (CEECs) and Former Soviet Union Republics, actual Confederation of Independent State (CIS), began transformation towards a market economy.[1] The change was very significant: both the economic and the institutional frameworks were significantly changed. Today in the CEECs and in CIS, there are guarantees of private property, new banks, new economic and administrative organizations, and other formal institutions exogenously imposed in a short time and by political decisions. Yet the behavioral rules have

[1] I include in the analysis, as transition economies, also Yugoslavian Republics and Albania. On the contrary, this paper does not refer to China, Vietnam and other Communist countries, which to some extent have begun a transformation towards a market economy.

not completely changed. Institutions are defined as "a set of social rules that structure social interaction" (Knight, 1992: 2). Consequently, in order to change institutions those prevalent social rules need to be changed. Informal economic institutions (i.e. not codified and prevalent social rules) are far from a completed change. Economic agents often continue to think in terms of a previous economic logic.

Given the concept of institutions, including both formal and informal institutions, it is no longer sufficient to change formal institutions in order to achieve another system. What is more important is to "change the mentality" of economic agents. I argue that old institutions may continue to function in the new system even if they are inefficient because current institutions are contingent on the past. There exists a self-reinforcing process which allows for the path-dependency of institutions. Moreover, interaction between new formal rules and old social customs will affect the evolutionary path of institutions. In fact, in transition economies, certain institutions survive, even if they appear inefficient, while others disappear. That is why each society has its own history, its path of development, its habits and its behavioral rules. In other words its own values (North, 1990).

Therefore transition from a planned system towards a market economy cannot be realized simply through the introduction of reforms. Neither development will easily be archieved. In order to start up a development process, transition economies need a radical transformation which involves social norms and informal institutions, relationships among the various powers, values and lobbies. Hence, development might be defined as economic growth through institutional change. As Kuznets (1965: 30) states: "The transformation of an underdeveloped in developed country is not merely the mechanical addition of a stock physical capital: it is a thoroughgoing revolution in the patterns of life and a cardinal change in the relative powers and position of various groups in the population [..]. The growth [..] must overcome the resistance of a whole complex

of established interest and values". In line with this approach, I argue that capital and human accumulation as well as technology and macroeconomic stabilization programs are necessary conditions, yet they are not sufficient conditions for economic growth because an institutional framework which regularizes the use and the distribution of those factors is required.

During this process, institutional policies and role of the State are needed. However, the role of institutions, in particular at the beginning of the transition process, has been largely underestimated or ignored. At the beginning of the transition process, the prevalent idea among economists and international economic organizations was an "anti-institutional" approach to resolve the economic problems of transition economics. The *Washington Consensus* in a few of its ten points "suggested" abandoning many institutions of economic policy (Williamson, 1990). Moreover, the World Bank and the International Monetary Fund (IMF) advised very strict fiscal and monetary policies for all the transition countries indifferently. The result was a significant recession. Furthermore, a state of institutional *vacuum*, chaos and disorganization in the economic framework was created. Oliver Blanchard (1997: 10) refers to this period as a *systemic vacuum* and as an economy of chaos.

I argue that if the formal economic institutions are neglected, informal institutions and processes of spontaneous forces prevail. This informal institutionalization may also be *parastatal* or illegal. Examples include: the mafia, organized crime, a corrupt bureaucracy, an informal economic network among agents, lobbies, etc. These forces fill the systemic *vacuum*. These kinds of informal institutions will generate an informal and illegal economy. Economic underdevelopment forces will prevail and human development will be lowered. Moreover, economic relations will be weakened and transaction costs will increase, negatively affecting economic growth.

In such a situation, transition towards a market economy would favor to better organized groups, *elite*, more western oriented regions, trade oriented firms, people and groups in dominant position, while could bring about disadvantages to less organized groups, firms and lobbies dealing with traditional sectors such as agriculture and heavy industry and which are experiencing a restructuring process, periphery regions, etc. Therefore development will be uneven poverty will emerge, and recession could take place in many regions, increasing cleavages and curbing development.

Central and Eastern European Countries and CIS experienced such an evolution (Nuti, 1999). Just after the fall of the Berlin wall, systemic change caused a huge recession (Kornai, 1994). Moreover, *vacuum* power and economic disorganization deepened the economic crisis (Blanchard, 1997). Finally implemented policies were not always able to withstand the crises and solve economic problems. On the contrary they often caused unnecessary overshooting, monetary squeezing, lack of investments, the over-hasty abandoning of the economy by public firms, and fiscal policies that were too austere (Kolodko and Nuti, 1997). After economic recession, a few transition economies such as Slovenia, Poland, Hungary and the Czech Republic started to grow and to recover income level, reaching and sometime overtaking the pre-1989 GDP per capita level. In the mid-Nineties, those countries (in particular Slovenia and Poland) implemented institutional policies and governance processes which allowed first an increase in the human development level and then a fast GDP growth. However, in the rest of transition economies human development, measured using the Human Development Index (HDI) of United Nations Development Programme (UNDP), was not always parallel with GDP growth .

On the contrary, we can observe evidence of growth, or economic recovery, without a consistent development. But in general, only countries which experienced increase in the human development level had a sustained economic

growth. Hence it seems to us that, in transition economies, human development is a sufficient, although not a necessary, condition for economic growth. It means that there may be economic growth without human development, but if there is human development then there will be economic growth. Hovever, this has to be tested (section 6).

Human development is a process of enlarging people's choices. Enlarging people's choices is achieved by expanding human capabilities and functioning (Sen, 1999). At all levels of development the three essential capabilities for human development are for people to lead long and healthy lives, to be knowledgeable and to have a decent standard of living. If these basic capabilities are not achieved, many choices are simply not available and many opportunities remain inaccessible (UNDP, 1999).

Section 2 and 3 describe the main policies and strategies implemented during transition. In all transition economies, the great transformation led to a great recession. GDP recovery and different development paths will be analyzed. In section 4 I will focus on the social costs of the transition, trying to find some causality relations with policies and institutions implemented. In section 5 I will adopt a Human Development approach in order to analyze the results of the transition. In section 6 I will test my main hypothesis, i.e. whether GDP growth requires human development. For this purpose an OLS model was used in order to correlate human development variables (i.e. life expectancy index, education index) with GDP per capita. In the final 7th section, I will discuss the role of institutions and governance in transition, trying to understand why some countries (i.e. Poland and Slovenia in particular) performed better. I will focus on the case of Poland. Some conclusions will follow.

2. The great transformation

Central and Eastern European Countries differ significantly in terms of economic performance, although economic policies advised by international organizations and implemented by national authorities are quite similar. Those countries were also different under centralized planning. Initial conditions among CEECs were very different. Economic structure (i.e. productive specialization, labor division, technologies, output etc.) was diverse, as well as rules, aims and planning, were diverse in spite of common membership of the communist block (Falcetti *et al*., 2000).

The transition, or better, the great transformation, is even more difficult and complex to analyze if we consider the whole former communist archipelago, i.e Russia and the other former Soviet Republics (now Commonwealth of Independent States - CSI), the Balkan countries and CEECs. An approximate taxation would be possible considering EBRD indices which show the progress of former communist countries as regards reforms towards market economy institutions.[2] The leading group involves: Poland, Hungary and the Czech Republic, immediately followed by Slovenia, Slovakia and Estonia. There follows a smaller group made up of Latvia and Lithuania. On the other side there are countries which have made very little progress towards a market economy and still have an almost central planned system such as: Belarus, Turkmenistan e Tajikistan (Transition Report 2001). In an intermediate position there is a group of countries made up by some former soviet Republics such as Russia and Ukraine plus some Balkan countries such as Romania and Bulgaria (the next EU accession countries), Albania and the former Yugoslavian Republics with the exception of Croatia which has more similar features to the first group. All these countries (27 according to EBRD)[3] are generally

[2] EBRD (European Bank for Reconstruction and Development) indices rank between 1 and 4+. These indices concern the following variables: *Enterprise, Privatisation, Price liberalisation, Foreign Trade, Governance, Competition, Infrastructures, and Financial Institutions.* Poland, Hungary and the Czech Republic, which are the most advanced in the reform process, have the highest indices (Cfr Transition Report 2001).

[3] However, data are available for all but Serbia & Montenegro (hence 26 countries).

called transition economies. However, the transition process proceeds at very different and controversial paces and often in very critical political conditions such as civil war, dramatic political instability, dictatorship, etc (Chilosi, 2002).

Nevertheless Washington based international organizations had a common recipe for these countries. This recipe is known as *Washington Consensus* (Williamson, 1990). According to Nuti (1999), the Washington Consensus ideology allowed for the following interpretation of the transformation of former communist countries: *Transition = Liberalization + Privatization*. They believed – as Nuti (1999), critically, pointed out - that it was enough to liberalize prices, to privatize State Owned Enterprises (SOE), and to open the international trade in order to have an efficient market economy. After that, markets would take the place of central planners (Sachs 1991). Moreover, shrinking of monetary and fiscal policies would be a complementary requirement.

Economists' views on these policies have been quite controversial and diverse. Some economists criticize the timing of implementation; others criticize the intensity of policies, and others the need and the appropriateness. This set of policies delivered important economic shocks, provoking a huge overshooting of the exchange rates which generated effects greater than those expected. The economic variables involved were:

Variables	**Aims**[4]
exchange rate	reduction of public expenditure and government balance
import tariffs, export subsidies, commercial policy	privatization of public assets and SOE
subsidies to firms and SOE	reduction of inflation
tax and fiscal policy	price liberalization
interest rate and monetary policy	competition and global economy integration
international regime	attract FDI
prices and wages	flexible wage but with anti-inflation anchors

[4] The table does not show a one-to-one correspondence between variables and aims.

At the beginning of transition the exchange rate in former CEECs was overvalued. It was made convertible by a government decree and strongly undervalued[5]. The average of trade tariffs fell immediately. In Poland for instance it fell from 18.5% to 5.5% (MacBean, 2000). The effect of these policies in some cases generated a trade surplus (as in Poland in 1990) which many economists considered not necessary (Nuti, 1996). In some countries (i.e. Poland, the Czech Republic) the IMF transformation recipe was implemented through a "shock therapy" strategy, in others (Hungary, Slovenia) a more gradual approach was adopted (see table 9 for an overview of all countries). Nevertheless the aim, in both cases, was to introduce a market economy and to reduce or to eliminate the role of the State in the economy. It is important to underline that countries such as Hungary and Slovenia adopted a gradual program of macroeconomic stabilization and reached similar results to those of Poland and the Czech Republic, which implemented a shock therapy program. On the contrary Russia and Bulgaria, which also implemented a shock therapy program, had very negative performances. This seems to confirm that macroeconomic policies are context-dependent, i.e. they depend on the country or region where they are implemented, and their success or failure depends on many factors such as: initial conditions, local institutions, agents' behavior and reaction to implemented policies, social context and culture, acceptance by agents, legality and trust, appropriateness of policies etc.

Kolodko (1997) and other economists' criticism[6] of the shock therapy is not because the so-called *gradual* process was not implemented *a priori*. Instead the main criticism is against some unnecessary shocks and measures that squeezed the economy and caused excessive overshooting. Some measures of the "shock therapy" package, such as price liberalization, legalization of private ownership,

[5] In Poland the zloty was devaluated by about twenty times the purchasing power parity (PPP) index. In Hungary the national currency was devaluated by about 5 times the PPP and in Czech Republic by about 3 times the PPP. See Nuti 1996.

[6] For instance, Nuti (1996); Calvo and Coricelli (1993).

unification of exchange rate, and some liberalization of trade were necessary. However, the extension of those measures should be proportionate to the country's initial conditions and should be announced *a priori* by the government. Other measures, such as the change in institutions and organizations, the regulation of FDI, the opening to global markets, global competition, the organization of governmental and economic agencies, the privatization of large and strategic SOE etc, require more time and spread of information. Finally, other pragmatic measures, such as lowering import tariffs, should be considered in terms of a choice between gradualism and speed.

I argue that the shock therapy should not have been implemented *tout court* just because the transformation from central planned economies to a market economy was incumbent, but the costs and benefits of different choices should have been analyzed. Each single policy should be implemented taking into account these trade-offs and depending on the results of single decisions. *"The Big Bang* [or shock therapy] *not only ignores the lessons of history, it fails to provide the social and economic condition necessary to create a market economy. The basic error lies in the mistaken belief in the spontaneous appearance of capitalism market economy once property right is privatised, prices are set free, the currency is stabilised and unregulated competitive markets are introduced. This error of spontaneity creates serious impediments to discussion of the policies that will have to be formulated in a successful transformation strategy".*[7]

Moreover, a shock therapy, by definition, does not pay attention to social problems of transformation. On the contrary it focuses only on macro economic problems. Hence development dimensions, such as life expectancy, education level and living standards are not considered directly. The shock therapy approach assumes as a main hypothesis the old neoclassical paradigm according to which

[7] Cfr. J.A. Kregel and E.Matzner, (1992: 35)

development will come only after a macro stabilization and a GDP growth. At the same time a gradualist approach during transition would not be the first best *per se*. A gradualist approach would be an appropriate approach during a transformation only if development dimensions were considered as main targets, institutions were considered as key factors of development, and governance at different spatial levels, i.e. local, regional and national, managed the transition process. Transition is a very complex process; in the market economy the capital and labor allocation is completely different than in the centrally planned economy. All the formal institutions such as stock exchange, banks, investment funds, trade unions, property rights, enterprise confederations, and others are new. Their development is slow and affected by a "learning by doing" process. Because of that, a shock therapy (if it is conceived as *Cold Turkey*[8] *tout court* and not as single policies with trade-offs for each variable) was a poor strategy and likely brought important recession in the early 90's in Poland, and in several other CEECs, or in Russia and in other former Soviet Republics, in the mid-90's. On the contrary, the Chinese strategy of building market institutions by a gradual process, and implementing single policies has probably secured a more durable and sustainable economic growth[9]. The great transformation was concurrent with a huge recession. In CEECs recession was from 20% to 40% of GDP, while in former Soviet Republics it was even worse and GDP fell in some cases by 60% of GDP. (See Appendix, table C)

At the same time economic recovery was faster and more consistent in CEECs than in CSI. After ten years of transition, only few States reached or exceeded the 1989 level of GDP (i.e. Poland, Hungary, Slovakia, and Slovenia). The rest among CEECs

[8] This is defined in the Oxford Dictionary as 'abrupt withdrawal from addictive drugs'.
[9] During the 1990-2000 period, Russia's economy lost 50% of GDP, the Chinese GDP has doubled and Poland's GDP has increased by 27% .

were still below that level. In the CSI the situation is even worse with an average level of GDP at 61% of the 1989 figure. (Appendix, table C)

The reasons of that different performance lay in the diverse initial conditions, different policies, and mistakes of policy makers (De Vincenti, 2002; Nuti, 2001). In general, after 15 years of transition, is widely accepted that governance and appropriate institutions are the key to the best performing countries during transition (Tridico 2004). During this process public interventionism and importance accorded to rules and institutions are necessary for a well-functioning market (De Vincenti, 2002: 12).

3. The great recession

According to Mundell (1997) in the early 90s, Central and Eastern European Countries and CIS *experienced the biggest recession that happened in the economic European history during peace time*. During this time, poverty and unemployment emerged. The *Big Depression* of 1929/30 generated similar phenomena but of smaller proportion. Mundell compared such crises only to *The Big Plague (or the Black Death)* of the XIV century. In Poland, where the recession was smaller, the GDP fell by almost 20%, unemployment increased continually and the inflation rate reached dramatic levels. *Poland lost at least a decade of development* (Baldwin, 1994). In the following table we can observe the slump of the GDP in the early 90s and the following recovery among the best performing countries:

Table 2. GDP change 1989-2001. Selected Countries.

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	GDP level 2000, (1989=100)
Poland	0.2	-11.7	-7	2.6	3.8	5.2	7	6	6.8	4.8	4.1	4	1.8	127
Czech R.	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.8	-1	-2.3	-0.8	3.1	3.5	104
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	4.5	98

Source: Transition Report, 2001

The IMF forecasts about transition economies were wrong – as Gomulka, a former shock therapy supporter, recognised: for instance in Poland, where a

shock therapy was implemented under IMF advices), the assumptions concerning GDP growth was: - 3.5% in 1990 against an actual - 11.4%, and +3.5% in 1991 against an actual – 7.4%. *"...The IMF team produced estimates, dated December 5, 1989, that predicted the following monthly inflation rates: 42.6% in January, 16.6% in February and 4.9% in March 1990"* (Gomulka, 1995: 320)[10]. Between 1990-1991 Poland experienced a cumulate GDP recession of -18.8%. Inflation in 1995 was still at 27.8%.

Interestingly, Svejnar (2002) wonders whether recession was inevitable or necessary. Of course the answer is not easy. According to Janos Kornai (1994), that recession was an inevitable transformational recession as a consequence of the systemic change in the economy and its institutions. Nevertheless, in the relevant economic literature several reasons are observable which may explain that recession:

1. The immediate collapse of the important communist trade block known as Comecon(Nuti, 2001).
2. The institutional *vacuum* generated by the abrupt end of the previous system and the lack of an immediate substitute (Blanchard, 1997).
3. Bad working of allocation of goods and inputs, generated by uncertainty, lack of trust, crime, and chaos at the beginning of transition. Market exchanges were not developed, hence transaction costs and lack of information were very important (De Vincenti, 2002).
4. Errors and omissions contributed to deepen recession (Nuti, 2001). Mistakes of policymakers such as: fiscal squeeze, penalization of public sector, over protection of exchange rates, often over valuated, with a very high interest rate, waste of monetary reserve in order to sterilize huge in-flow of foreign

[10] "In early 1991, the flaws of the program were already apparent, but there was not time to renegotiate it, because on March 18, 1991, the Paris Club offered Poland an immediate 30% debt reduction. Conditional only on her having a Fund-supported economic program. The condition was met on April 18, 1991, and the reduction was granted on April 19, 1991". (Gomulka, 1995: 337).

capitals attracted by high interest rate, credit squeeze and credit rationing. Omissions on the part of the new governing class such as: public wages and pensions which were not paid in order to curb *deficit*; non-payment of public purchases. Lack of public investment, either ordinary or extraordinary. All this caused a strong de-monetization and often a barter (swap) economy.

5. The monopoly-type market strength of the new privatised undertakings which had inherited the old structure of the previous regime without any prior re-structuring.
6. No attention was paid, in particular at the beginning of transition, to an institutional matter: institutions were not considered to be important for development; public institutions were neither substituted nor created; standards policies (i.e. the Washington Consensus) and international constraints were just accepted and implemented; culture, social capital, domestic norms and values were simply ignored; path-dependency theory was not considered relevant, etc[11].
7. Moreover, the immediate liberalisation of prices targeting the elimination of distortions caused by the former artificially and badly price administration system, brought about the emergence of repressed and hidden inflation. Such a distortion in prices did not allow for an efficient allocation of productive resources and goods. As Nuti (1986) explained, such a distortion was one of the origins of repressed and hidden inflation during the 1980s in many former communist countries. During socialism the problem was that prices were administered and therefore not free to clear the market. So, the elimination of the gap between demand and supply was necessary. That mis-matching was the origin of the high inflation in Poland as in other CEECs as well as the origin of the well-known phenomenon of queues at the retail shops.

[11] Cfr. J.A. Kregel and E.Matzner, (1992); Murrel (1992).

However, as De Vincenti (2002) pointed out, the fall in production, caused by the abrupt closure of state owned enterprises, the decrease in employment, and consecutively in the aggregate demand, contributed to increase the inflation rate. Hence, a vicious cycle of Keynesian origin dominated the slump of former communist countries. Therefore, Keynesian policies should have been implemented instead in order to cope with that recession.

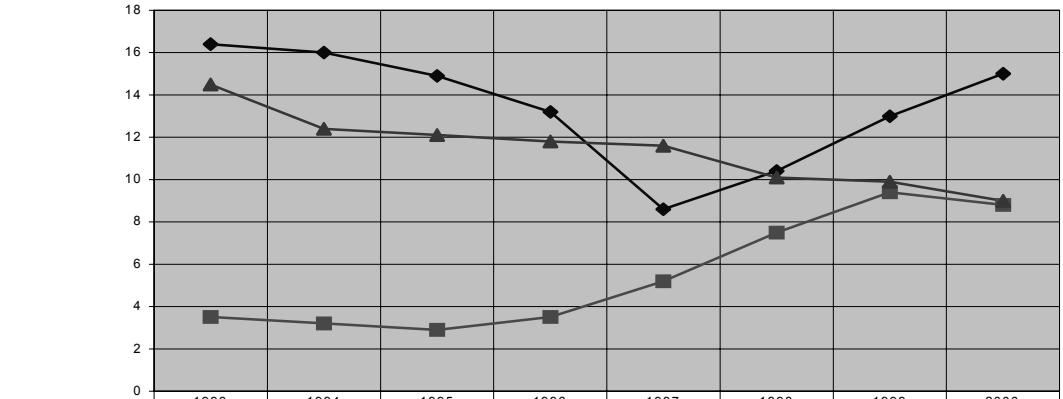
4. The social cost of transition

In the first years of transition, the most important aim of Government was macro-stabilisation (Balcerowicz, 1993): the fight against inflation, the reduction of debt, the liberalisation of prices, the budget balance and privatisation. All these aims were considered necessary by international organisations and main stream economists to allow economic growth. Nevertheless these results were not sufficient to stimulate long-term and sustainable growth.

Transition economies are affected by very high unemployment rates, a growing inequality rate (measured by GINI-coefficients), a considerable index of poverty (where, according to OECD, the percentage of workers represents the majority), a chronic current account deficit and a considerable foreign debt. Moreover informal economy and corruption levels strongly persist (Kaufmann et al., 1995). Obviously, among transition economies, situations are highly differentiated. Among the most advanced CEECs it is evident that Hungary, the Czech Republic, Estonia, Slovakia and Slovenia experienced a smaller recovery in GDP, in comparison with Poland, but a lower poverty rate, a lower inequality level, a lower unemployment rate, a lower corruption level and a lower informal economy level. This can be partly explained by the fact that Poland, during the first part of 1990s adopted an extreme "shock therapy" aiming at macro economic

stabilisation, which had the effect of squeezing the economy, increasing unemployment and reducing people's purchasing power (Kolodko and Nuti, 1997).

Figure 1. Unemployment rate in %. Selected Countries



	1993	1994	1995	1996	1997	1998	1999	2000
Poland	16,4	16	14,9	13,2	8,6	10,4	13	15
Czech Rep.	3,5	3,2	2,9	3,5	5,2	7,5	9,4	8,8
Hungary	14,5	12,4	12,1	11,8	11,6	10,1	9,9	9

Source: Transition Report 2001

During transition many people became poorer. Economic benefits were not well distributed and today, in particular in the former Soviet Union, the majority of people have a lower living standard than before 1989. The impoverishment of the people is the consequence of the economic crisis of the early nineties: a huge fall in output, very high unemployment, the reduction in real wages and a rise in income inequalities. However the increase of poverty was different among countries (Ruminska-Zimny, 1997)

Most of the poor people are concentrated in former Soviet Republics, where the initial poverty level was already significant, while in Slovenia, Hungary, the Czech Republic and Slovakia the increase of poverty was modest (around 6%-9%, according to UNICEF 1995[12]). Among CEECs a high level of poverty incidence is remarkable in

[12] UNICEF measure of poverty line is equal to 60% of the low income. The low income was defined as a percentage between 35-60% of the average wage of 1989. In this way poverty line is not measured in absolute

Poland, considered to be one of the advanced transition economies in reforms and economic performance (around 18%). At the same level there are Romania and Bulgaria. Baltic countries and Slavic countries of CSI experienced an important increase in poverty level, reaching the level of 40-46% in Estonia, Lithuania, Ukraine and Russia, 65% in Moldova and 23% in Belarus and Latvia. In the Asian Republics of CIS, where pre-1989 poverty was already important, the poverty level reached dramatic levels: above 50% in Uzbekistan, Kazakhstan and Turkmenistan; around 76% in Kyrgyzstan; between 80-90% of the population in Tajikistan. In the Caucasus, poverty is exacerbated by military conflicts and civil war. UNICEF (1995) estimates a poverty level in Armenia and Azerbaijan around 65%; in Georgia, wages ($ 5 a month) are below the minimum subsistence of $ 31 a month (Ruminska-Zimny, 1997).

Table 3. Poverty Index 1995 – selected countries

POLAND	18.3%
HUNGARY	9.3%
SLOVAKIA	6.7%
CZECH REPUBLIC	6.1%
Former East GERMANY	6.6%

Source: UNICEF 1995

It is noticeable that despite the fact that Poland, first among the CEECs to start a transition process towards a market economy, has done remarkably well compared to the other CEECs as regards the macro-stabilisation of economy, still the Polish economy is affected by numerous problems which curb economic performance. The consistent rise of poverty was caused by the collapse of the GDP, the dramatic fall in real wages, and by the increase of inequality. After 1992, poverty level stabilised at a high level, but inequality continued to increase. Inequality was due to many factors such as liberalisation, privatisation and wage differences among people. The ensuing

terms but reflects the condition of the specific country. In fact a poverty line of PPP $ 4 a day (as considered by Milanovic 1996) would be to low for CEECs and would be to high for CIS.

fast growth caused important wage differences between skilled and unskilled workers (Rutkowski 1996).

The same can be said for Bulgaria, Romania, and for the Baltic Countries, which among CEECs, have the worst social indicators, i.e.: unemployment rate, poverty rate and inequality reach the same level as in Poland. The dynamic of the Gini-coefficient shows a consistent increase of inequality in the first part of transition in Poland (when a shock therapy was implemented), while in the second part it was more stable.[13]

The same figure appears in another "shock therapist" country, i.e. the Czech Republic. On the contrary Hungary managed the transition through a gradual therapy, more social oriented and institutionally aware.

Table 4. GINI Coefficient dynamic 1988-2001

	1988	1995	2001
POLAND	25.6%	32.1%	33%
CZECH Rep.	19.4%	25.8%	27%
HUNGARY	21%	24.2%	26%

Source: Atkinson and Micklewright 1992. Transition Report 2001

Economic transition was very costly in social terms, in particular in the former Soviet Union. Those countries, together with the countries of the former Yugoslavia, experienced tragic events, civil wars, crime domination and economy of chaos. Moreover, even in the case of those countries, international financial organisations suggested that the State should abandon the economy and implement a Washington Consensus oriented policy. Therefore they did not implement any institutional policies which would allow for an institutional governance, for the protection of weaker and poorer people, or for conflict management. On the contrary, the sudden introduction of the market economy and the end of social policies, welfare state and income redistribution policies caused an increase in poverty, inequality and unemployment (Adam 1999).

[13] As we will see in section 7, in the second part of transition, Poland implemented a very social oriented and institutionally aware strategy of transformation.

Table 5. Gini coefficient %, in 2004

Slovenia	28.04	Bulgaria	31.09	Armenia	37.09
Czech Rep	25.04	Russian Fed	45.06	Turkmenistan	40.08
Estonia	37.02	Macedonia, T	28.02	Azerbaijan	36.05
Poland	31.00	Belarus	30.04	Georgia	36.09
Hungary	24.04	Albania	28.02	Uzbekistan	26.08
Lithuania	31.09	Bosnia and H	26.02	Kyrgyzstan	29.00
Slovakia	25.08	Romania	30.03	Moldova, Rep	36.02
Croatia	29.00	Ukraine	29.00	Tajikistan	34.07
Latvia	32.04	Kazakhstan	31.03		

Source: UNDP, Human Development Report 2004

In a very interesting article, Kovalik (2001) states that "best performing" transition economies are still affected by many social problems, problems eliminated or greatly reduced by the older EU members long ago. He refers to the increase in poverty, inequality, corruption, gender discrimination, high unemployment, poverty among farmers and workers, dualism and increase of income divergences between regions of the same country, and other social problems. The "worst performing" transition economies are more greatly affected by those social problems, and their transformation seems to worsening human indicators such as life expectancy, education level and living standards.

Hence, in general we can say that many shadows darken the balance of that transformation and the economic cost in terms of unemployment, poverty, reduction of well-being, and increase of inequality are very consistent. "It seems therefore, and perhaps it is not surprising, that the transformation of former communist countries has passed from a central planning system pure and simple underdevelopment, with the hope but not the certainty of a faster path towards the prosperity of advanced countries with a market economy" (Nuti, 1999). [14]

[14] Nuti D.M., "1989-1999: la grande trasformazione dell'Europa centrorientale", Europa/Europe, Nuova Serie, Anno VIII Numero Quattro, Bollati Boringhieri, (VI paragraph, own translation) 1999.

5. A Human Development approach

The idea that the GDP is an absolute and reliable measure of development has been widely criticised by aware development economists. Performance of countries in terms of GDP can be very different from basic development indicators (Noorbakhsh, 1996; Costantini and Monni, 2005). Morris (1979) was among the first to elaborate an index of socio-economic development ("the physical quality of life index"), which was built on the basis of three indicators, i.e.: infant mortality, literacy, and life expectancy. The United Nations (UN) were always very sensitive about the socio-economic level reached by countries. According to the UN, it was clear that development does not mean growth. During the seventies, the UN started to study a different economic development approach according to which developing countries should satisfy some "basic needs", through public policies (Streeten, 1979). The following theoretical contribution of Amartya Sen (1985), and his "capability approach", was crucial for further investigations about development indicators. In 1990 the United Nations Development Program (UNDP) published its first Human Development Report where a composite index of human development (HDI) was presented.

A good deal of empirical evidence shows that both in developing and in developed economies, some countries have relatively high GDP per capita but very low indicators of development such as literacy, access to drinking water, rate of infant mortality, life expectancy, education, etc. This is in part due to the fact that wealth is unequally distributed. Vice versa, there are cases of relatively low GDP per capita and high indicators of development in countries where income is more equally distributed (Ray 1998). For instance Guatemala has a GDP per capita higher than Sri Lanka, but inequality is much higher in Guatemala. Development indicators are much better in Sri Lanka than in Guatemala. Life

expectancy (years): 72 against 65; infant mortality rate (per 1000): 18 against 48; Access to safe water (% of pop.): 60 against 62; adult literacy rate (%): 89 against 54 (Human Development Report, UNDP, 1995). Examples like this are numerous and non-perfect correspondence between GDP and Development indicators can be observed even in industrialised countries, where there are more resources to distribute. As a result, the UNDP taxation of Human Development Indexes and GDP rank, is not at all coincident (Human Development Report, UNDP, 1999).

The UNDP Human development Index is a composite index, ranking between 0-1, which is the combination of two non-income dimensions of people's lives and one income dimension. The first one is life expectancy at birth, which reflects infant mortality too. The second one is educational attainment, which is a combination of primary, secondary and tertiary educational level and adult literacy rate. The third element is an adjusted GDP index which reflects income per capita measured in Purchasing Power Parity (PPP) at US$ (Human Development Report, UNDP, 1990).

According to the UNDP definition, human development is a process of enlarging people's choices. That is achieved by expanding human capabilities and functioning (Sen, 1999). In order to expand human capabilities institutions are needed. Institutional policies would allow for improving the three essential capabilities for human development: i.e. leading long and healthy lives, being knowledgeable and having a decent standard of living. This approach assumes that economic growth requires first of all investment in human development. Poor countries such as China, Sri Lanka and Indonesia had relatively high human development levels and a very low GDP per capita in 1975. Development economists mostly agree that these higher human development levels made it possible for them to have a faster growth (UNDP, 2004). Today those countries have

relatively high GDP per capita, in comparison with other developing countries.[15] On the contrary in 1975 poor countries such as Pakistan, Ghana, and Nigeria had very low levels of human development, and after 25 years they are still poor, with very low GDP per capita.[16]

Of course the link between human development and growth is not automatic. The evidence is very controversial. For instance there is evidence of a stable or improved level of human development together with economic decline, such as in Tajikistan; or again human development in a reverse direction with respect to economic growth such as in the case of Botswana, which experienced good economic growth with a reduction in human development level (from 1975 to 2002), due to worsening of life expectancy and health levels. In the next section I will test my causality relation hypothesis (i.e. Human Development → GDP growth in the case of transition economies). Mainstream economists argue that GDP is the best proxy for development, but then they can not hidden the numerous evidences of growth without development[17]. Hence it seems to us that a composite index of human development, where a GDP is only one of the different elements which determine it along others which concern human life, is the best proxy, indeed, of "development" as it is widely intended.

6. Human development and economic growth in transition Economies

The human development level in transition economies is relatively high thanks to previous investments made in social dimensions by previous regimes. Nevertheless, the transition process influenced the non-income dimensions of

[15] China's GDP per capita, in PPP US$, in 2002 was 4.580, Sri Lanka's GDP per capita, in PPP US$ in 2002 was 3.570, Indonesia's GDP per capita, in PPP US$, in 2002 was 3.230 (UNDP 2004).
[16] Pakistan's GDP per capita, in PPP US$, in 2002 was 1.940, Ghana's GDP per capita, in PPP US$ in 2002 was 2.130, Nigeria's GDP per capita, in PPP US$, in 2002 was 860 (UNDP 2004).
[17] For details about this debate see: Anand and Harris 1994; Desai 1991; Naqvi 1995; Srinivasan 1994; Streeten (1994).

people, often worsening the main indicators. (Ruminska-Zimny, 1997). Death rates increased and life expectancy declined in particular in CIS and in the Baltic States. The second dimension of HDI, i.e. access to education, slowed too. After 1989, public expenditure on education decreased as a consequence of GDP fall, and the public education system worsened. The same as regards public expenditures on health, which contracted in many countries because of the slump in GDP. Moreover, lack of investments and technology in this sector contributed to reduce the quite high standard of those countries during the previous regime. Today, services and performances are negatively affected by obsolete infrastructures, hospitals, machines, etc. Very often, the privatization of health care services contributed to create a second class health care system. People with low income, and in general the losers of the transition, cannot afford the more expensive and more advanced private heath care services.

However the situation is very different among CEECs and CIS, and further detailed observations are needed. First of all, transition economies have an average level of human development (0.796) above the world average (0.729), and higher than all other countries, except for OECD countries (0.911), as a heritage of the communist era. However, I have to say that unlike developing countries, in transition economies, Human Development Index does not capture all dimensions of development and of individual well-being, because one important variable is missing, that is unemployment rate. If that neglecting can be tolerated for Developing Countries analyses, it is difficult to justify in former communist countries, where unemployment level was very low before 1989 and increased dramatically during the transition process.[18]

Secondly, different initial conditions (at the starting date of transition 1989/1990) among transition economies are evident in terms of human

[18] In fact this type of criticism can be accepted and can be an incentive for further researches. Sen (1987) says that in some case the simple HDI does not capture all dimensions of development.

development and in terms of GDP per capita. Thirdly, countries which implemented institutional policies, social policies and a governance recovery, filling the initial power vacuum, increased their level of human development. Finally, countries with higher level of human development performed better in terms of GDP growth and recovery than countries with lower level of human development (see Appendix, table B). Therefore, a higher level of human development, seems to be the major cause of a faster economic growth. On the contrary, countries which did not implement such institutional policies did not increase their level of human development and economic growth was neither fast nor sufficient to recover the pre-1989 level of GDP per capita.

Table 6. HIGH HUMAN DEVELOPMENT

"relative" HDI rank	countries	HDI index		"relative" GDP rank	countries	GDP index*	GDP PPP $	HDI-GDP**
1	Slovenia	0,895		1	Slovenia	0,87	18,540	3
2	Czech Republ	0,868		2	Czech Republ	0,84	15,780	7
3	Estonia	0,853		3	Hungary	0,82	13,400	10
4	Poland	0,85		4	Slovakia	0,81	12,840	13
5	Hungary	0,848		5	Estonia	0,8	12,260	3
6	Lithuania	0,842		6	Poland	0,78	10,560	10
7	Slovakia	0,842		7	Lithuania	0,77	10,320	1
8	Croatia	0,83		8	Croatia	0,77	10,240	4
9	Latvia	0,823		9	Latvia	0,75	9,210	6
10	Bulgaria	0,796		10	Russian Fed	0,74	8,230	10
11	Russian Fed	0,795		11	Bulgaria	0,71	7,130	3
12	Macedonia, T	0,793		12	Macedonia, T	0,7	6,560	15
13	Belarus	0,79		13	Romania	0,7	6,470	24
MEDIUM HUMAN DEVELOPMENT								
14	Albania	0,781		14	Bosnia and H	0,68	5,970	31
15	Bosnia and H	0,781		15	Kazakhstan	0,68	5,870	15
16	Romania	0,778		16	Belarus	0,67	5,520	5
17	Ukraine	0,777		17	Albania	0,65	4,870	25
18	Kazakhstan	0,766		18	Ukraine	0,65	4,830	4
19	Armenia	0,754		19	Turkmenistan	0,63	4,300	33
20	Turkmenistan	0,752		20	Azerbaijan	0,58	3,210	16
21	Azerbaijan	0,746		21	Armenia	0,57	3,120	23

22	Georgia	0,739		22	Georgia	0,52	2,260	29
23	Uzbekistan	0,709		23	Uzbekistan	0,47	1,670	35
24	Kyrgyzstan	0,701		24	Kyrgyzstan	0,46	1,620	33
25	Moldova, Rep	0,681		25	Moldova, Rep.	0,45	1,470	36
26	Tajikistan	0,671		26	Tajikistan	0,38	980	45

Source: Author's elaboration on UNDP database (2004)

* Based on the life expectancy index, education index, and the GDP index;

** HDI rank minus GDP per capita (PPP US$) rank. A positive figure indicates that the HDI rank is higher than the GDP per capita (PPP US$) rank, a negative the opposite.

This is a very interesting point which is confirmed by a simple regression model. Using an OLS method I found out that GDP index is positively and strongly correlated with the Human Development Index (HDI). In the following regression I used the "Life expectancy index" and the "Educational index" as independent variables for human development, and the GDP index[19] as a dependent variable. I did not run a regression between GDP index and HDI (with HDI as the only regressor) since there could be an auto-correlation problem (the GDP index is one of the three dimensions included in the HDI calculation). The latter requires the first, and not vice versa.[20]

Table 7

Dependent Variable: GDP index

Method: Least Squares

Included observations: 26

Variable	Coefficient	Std. Error	P-Value
Life Expectancy index	1.661743	0.414746	0.0006*
Eucation index	2.127335	0.538301	0.0006*
Constant	-2.563643	0.627456	0.0005*
Adjusted R-squared 0.545264			

**Significance level at 1%. Source: Author's elaboration*

[19] The GDP index strongly reflects the GDP level in US$ Purchasing Power Parity.

[20] However, I do not want to conclude with a simple cross-country study that HDI determines GDP. In general it depends on dimensions of HD considered and of Countries analysed. Indeed, the debate in such field is quite vibrant. See for instance Desai (1991); Naqvi (1995); Ranis *et al*., (2003) for similar results. While Anand and Harris (1994); Srinivasan (1994), consider GDP as a good indicator for Human Development too. Ranis *et al*., (2000), recognise that both, GDP and HDI, are consistently correlated in both directions. However they conclude that, in terms policies, should be given sequencing priority to HD.

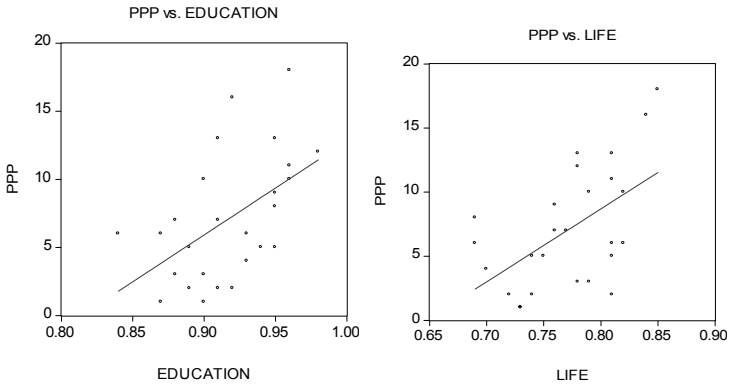


Chart 1. *Source: Author's elaboration*

In order to confirm our direction causality hypothesis and results, at least in the specific case of transition economies, I present data with GDP index as an independent variable, and Human development dimensions (Life expectancy and education) as dependent variables, singularly taken. We can observe a much lower level of R-square and significance with a lower level of *P-value,* and a lower magnitude of coefficients in both regressions in comparison with the previous one.

Table 8

Dependent Variable: Education index				**Dependent Variable: Expectancy index**			
Method: Least Squares				Method: Least Squares			
Included observations: 26				Included observations: 26			
Variable	Coefficient	Std. Error	P-Value	Variable	Coefficient	Std. Error	P-Value
GDP	0.190107	0.048105	0.1006**	Education	-0.639671	0.233741	0.1118**
LIFE	-0.384008	0.140319	0.1118**	GDP	0.247367	0.061739	0.1006**
C	1.086289	0.097021	0.0000*	C	1.193062	0.198133	0.0000*
Adjusted R-squared 0.366889				**Adjusted R-squared 0. 373947**			

** Significance level at 1%. ** = scarce level of significance. Source: Author's elaboration*

Very interestingly, the trend of the human development index during transition is very heterogeneous according to the policies and institutions implemented (see Appendix, table B). For instance in Poland HDI in the first part of transition (1990-1995) passed from 0.802 to a mere 0.816, while at the end of

the second part of transition (in 2002) it reached 0.85. That is why in the second part of transition good institutional policies, governance mechanism and reform were introduced. These policies made possible a recovery from the decline of the first part of transition, caused probably, at least partly, by a shock therapy program. In the second part of transition, in fact, a more oriented institutional program was implemented with the introduction of "Strategy for Poland". In Slovenia, on the contrary, a gradual macroeconomic approach to transition made possible the introduction of appropriate institutions and policies, avoiding the power vacuum which happened in other transition countries. The following table shows which kind of macroeconomic strategy, in general, transition economies adopted during 1990-2000.

Table 9

COUNTRIES	TYPE OF MACROECONOMIC STABILISATION
Eastern Germany	Immediately united to West Germany (particular kind of "shock Therapy").
Poland,. Czech Rep., Slovakia, Estonia, Latvia	Speed Reforms, started with a macro-stabilisation. Implementation of privatisation, liberalisation and trade openness policies ("shock Therapy" program).
Hungary and Slovenia	"Gradual" macro-stabilisation; strong institutional framework, gradual privatisation.
Bulgaria and Albania	Reforms started very late, but then implemented through a "shock therapy "; corruption.
Romania and Russia	Reforms started but then stopped, not-coordinated, bad managed, corruption.
Ukraine and Belarus	None or insufficient reforms, iper-inflation, unstable economies and politics, corruption.
Former Yugoslavia (except Slovenia). Other former Soviet Republics (Georgia, Armenia, Azerbaijan)	Military conflicts, civil wars, instability of politics and economies, no reforms, except for Croatia which started later a gradual and successful transition
Asian Republics of the CIS (former URSS)	Political instability, no reforms, longer and deeper economic recession, corruption.

Source: Lavigne, 1999

Slovenia and Poland together with Hungary and the Czech Republic are the best countries in terms of HDI trend and did not experience a negative change during transition. Consequently, those countries experienced a faster GDP growth and reached or overtook the pre-1989 level of GDP per capita before 2000. Between 1991 and 1997, Slovenia and Poland in particular adopted socially-oriented policies and institutions which made possible HDI growth and simultaneously GDP growth. However human development was not concurrent for all the countries with GDP growth during transition. On the other hand we can observe evidence of growth, or economic recovery, or relatively no recession, without a consistent development in the following countries: Albania, Latvia, Croatia, Lithuania, Estonia, Slovakia, Belarus and Uzbekistan. All these countries in fact reached, and in some cases (i.e. Slovakia, Albania and Estonia) surpassed, the pre-1989 level of GDP per capita between 2002 and 2004. In other countries, the level of Human development remained stable or decreased and the economy also collapsed. These countries are: Russia, Bulgaria, Romania, Tajikistan, Moldova, Kyrgyzstan, Georgia, Turkmenistan, Ukraine, Kazakhstan, Macedonia TFRY, Armenia and Azerbaijan. Plus Bosnia-Herzegovina and Serbia-Montenegro, whose data however are, obviously, not greatly significant or reliable. Uzbekistan, Kyrgyzstan, Tajikistan and Moldova have the lowest level of GDP per capita among all transition economies. Hence the empirical evidence is quite diverse and controversial, as the chart below shows. I should expect observations (*dots* for life expectancy index and *triangles* for education index) in the northeast and southwest parts of the chart, in order to confirm the positive relation between GDP and HDI. On the contrary we can see a lot of observations in the central part or even in the "wrong" part. For instance high GDP with low life expectancy index (southeast part in the chart). A smaller number of observations can be noticed in the northwest part of the chart (High education index and low GDP).

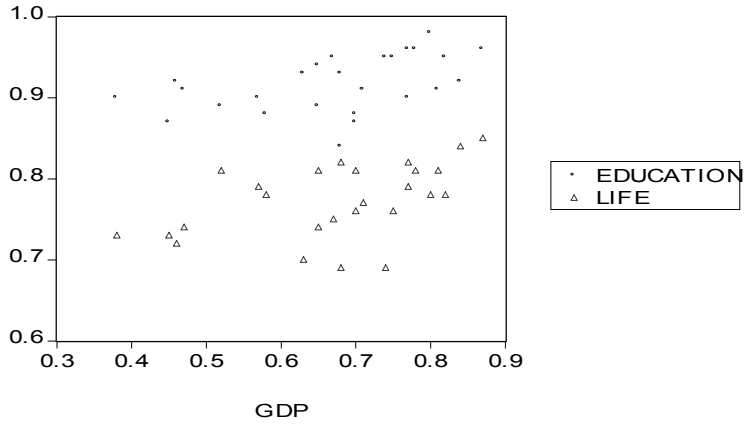
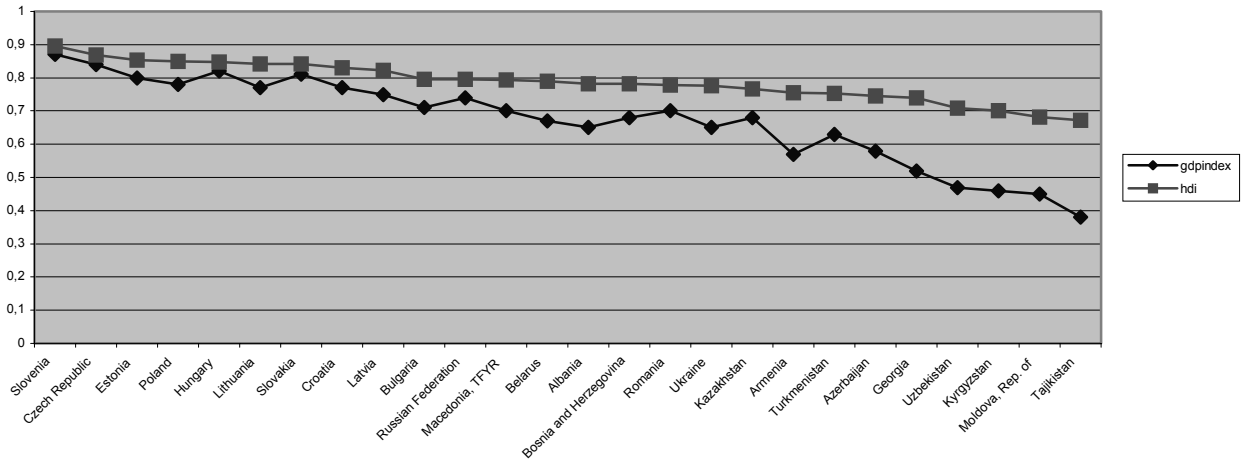


Chart 2. *Source: Author's elaboration*

In general, only countries which experienced an increase in their human development level had a sustained economic growth. Hence it seems to us that, in transition economies, human development is a sufficient, yet not a necessary, condition for economic growth. This means that there can be economic growth without human development, but if there is human development then there will be economic growth.

In particular, it seems that the factor which has a more important impact on the GDP level of analysed countries, is the education index, whose β coefficient, in the regression model above presented is 2.127335. While the β coefficient of life expectancy index is lower, i.e.: 1.661743. This reflects the life expectancy index average in former communist countries which is lower than the education index average, i.e.: 0.74 against 0.93.

Figure 2. GDP index and HDI



Source: Source: Author's elaboration on UNDP database (2004)

In the former Soviet Union the lack of any implementation of institutional policy was lethal. Socially oriented policies were suddenly substituted by the economy of chaos, and by a free market without institutions. The withdrawal of the State from the economy caused a colossal fall in output and an explosion of unemployment. Social indicators immediately worsened. As a result, the relatively high HDI of those countries decreased or, in the best of cases, did not increase during the 1990-2000 decade. Consequently economic growth was negative, as the following table suggests, and in many cases those countries still have not reached the pre-transition level of GDP per capita (see Appendix, table C).

Table 10. GDP growth and HDI change

	Annual_Average Gdp_Growth 1990-2002	% Change in HDI (1990/2002)		Annual_Average Gdp_Growth 1990-2002	% Change in HDI (1990/2002)
Slovenia	4,2	0,048*	Albania	6	0,101
Czech Rep	1,4	0,028*	Bosnia and H	18	NA
Estonia	2,3	0,042	Romania	0,1	0,008

Poland	4,2	0,056	Ukraine	-6	-0,027
Hungary	2,4	0,048	Kazakhstan	-0,7	-0,001
Lithuania	-0,3	0,022	Armenia	1,7	0,003
Slovakia	2,1	NA	Turkmenistan	-3,2	NA
Croatia	2,1	0,028	Azerbaijan	0,2	NA
Latvia	0,2	0,019	Georgia	-3,9	NA
Bulgaria	-2	0,001	Uzbekistan	-0,9	0,031*
Russian Fed	-2,4	-0,022	Kyrgyzstan	-3,2	NA
Macedonia,T	-0,7	NA	Moldova, Re	-6,9	-0,081
Belarus	0,2	0,006	Tajikistan	-8,1	-0,071

**% Change in HDI (1995/2002). Source: UNDP, Human Development Report 2004*

A simple regression model applied to the data above shows the strong relation existing between the annual average GDP growth during 1990-2002 and the percentage of change in HDI for the same period.[21]

7. Institutions, Governance and Development

As an important example of empirical evidence of good economic performance reached with good governance and institutions, I can present the case of Poland *at least* during the second phase of transition i.e. during 1994-1997. The better performance of Poland, in terms of GDP recovery, in comparison to other CEECs[22], is in fact the result of the high growth between 1994 and 1997 (see table 11). During that period in Poland a special economic and social program was implemented, the so-called "Strategy for Poland", which highlights, according to De Vincenti (1998: 57) a "new course in Poland". This program seems to create that institutional framework that was missing at the beginning of Transition.

[21] However in this case, with two variables only (i.e. GDP growth and HDI growth), serious autocorrelation problems would affect our model, whose data are hence not presented here.
[22] In fact Poland was the only Country, among CEECs and CIS, to overcame, during 1997-1998, the level of GDP of 1989.

Table 11. Poland: GDP change in % 1989-2001. GDP level 1989 =100

Years	1989	1990	1991	1992	1993	**1994**	**1995**	**1996**	**1997**	1998	1999	2000	2001
GDP change %	0,2	11,6	-7	2,6	3,8	**5,2**	**7**	**6**	**6,8**	4,8	4,1	4	0,2
GDP level	100		81						**100**			127	

Source: Transition Report 2002

"Strategy for Poland" confirms an important principle: if institutions are important for a development process, then institutional policies are fundamental. The guidelines of the new program target both macro economic stability and the reinforcement of the State's role in economy through public expenditure, infrastructure building, guarantee of welfare state, improvement of purchasing power of poorer people, protection of weaker people in the new market context, etc. With "Strategy for Poland" a new social pact between trade unions, business clubs, organisations and government emerged. That pact involved several groups and classes of Polish society such as: workers, retired people, business men, bureaucrats, foreigner investors, farmers, etc. This type of pact had been badly neglected during the implementation of the IMF program; the latter had aiming only at monetary stability, public budget, deficit reduction and anti-inflation target. Below I resume the main policies of that program.

- Public investments in order to build important public infrastructures
- Social policies aiming at giving "basic economic and social rights" (social institutions building)
- Rigorous fiscal policy but not necessarily avoiding deficit
- Building agency and services aiming at helping trade, matching of Demand and Supply and market exchanges in order to reduce transaction costs
- A minimum wage and guarantee against wages that were too low. Introduction of a system of wage agreement between trade unions, business clubs, and government

- Guarantee for previously accumulated pension contributions and social security
- A monetary policy that was less strict than previously, cutting of the interest rate, and saving for debt services.
- Easier access to foreign reserves with less strict rules for their accumulation
- Banking and financial policies in order to favour financial agencies, credit access, and trust between operators, firms and banks.
- Incentives for the emersion of firms from the black and illegal markets, fighting against corruption and crime.
- Gradual privatisation for bigger firms and faster privatisation for smaller ones.
- Policies helping legality, law certainty, property rights distribution, respect of contract, guarantee for foreign investors, etc.
- Introduction of an incentive system for agriculture similar to the one in force in the EU with Common Agriculture Policy
- Antitrust law and agency, consumer guarantee, information agencies for foreign investors, regulation of FDI in special zones,

Those policies are considered as a recovery of governance which allows for an improvement in human development and, consequently, a recovery of GDP after the huge recession of the beginning of 90s (De Vincenti, 1998: 60). That governance recovery was lacking and is still lacking in other former Communist countries such as Russia and other former Soviet Republics, some CEECs such as Romania and Bulgaria in particular. The financial crisis in Russia and in other CEECs such as the Czech Republic in the second half of the 90s seems to be originated from a lack of governance in the economic and financial system of those countries. Moreover the same lack of governance and appropriate institutions seems to cause a high level of the informal economy, corruption, uncertainty of property rights, mistrust, which negatively affect the economic performance of former Soviet Republics, Romania and Bulgaria, and, to some

extent, also the performances of the other CEECs, new members of the European Union. However, in general, UE's new member States are the most advanced in both reforms towards the market economy, and GDP recovery (cfr. EBRD indexes: Transition Report, 2001). For those countries, EU membership promise, has played the role of both a macroeconomic discipline and of an institutional convergence. Therefore, social and institutional policies were also implemented.

Through a "Strategy for Poland", during the years 1994-1997 the Polish economy took the right path towards a development process which involved not only a GDP recovery but also the informal economy, social security, education improvement and the fight against unemployment. However after that period that strategy was abandoned (Kolodko, 2004) and no longer implemented, with negative effects on social performances. Hence the Polish economic situation is not better today than other advanced CEECs (Hungary, the Czech Rep., Slovakia, Slovenia and Estonia). On the contrary, the unemployment rate is very high, as are the inequality and poverty indices. Moreover GDP growth during the first three years of 2000 was very low.

In order to reach a considerable level of human development and to make development less uneven, three conditions are fundamental, together with GDP growth. They are 1) management of social conflicts, 2) reducing inequality, 3) giving economic opportunities and to exploit those opportunities. Economic institutions play an important role in those aims. Olson *et al.* (1998) show that better governance and quality of institutions are the main sources of economic growth and determine the differences between the output of the various countries[23]. Along the same lines, Jones and Hall (1998) find that "Social Infrastructure" and governmental policies explain the different levels, among

[23] Governance and quality of institutions are measured by Olson *et al.*(1998) by means of various indices: *The Risk of Expropriation; The Risk of Repudiation of Contracts by Governments; Quality of Bureaucracy; Level of Corruption* ; *Law and Order Tradition; International Country Risk.*

countries, of a residual productivity, which in turn is at the basis of the level of those countries' output. Moreover Rodrik (1999) shows that better performing countries, in terms of GDP per capita, are those which succeed in managing social conflicts through appropriate institutions. *The world market is a source of disruption and upheaval as much as it is an opportunity for profit and economic growth. Without the complementary institutions at home – in the area of governance, judiciary, civil liberties, social insurance, and education – one gets too much of the former and too little of the latter. The weakness of the domestic institutions of conflict management was the Achilles' heel of the development strategy pursued in Latin America, the Middle East, and elsewhere, and this is what made countries in these regions so susceptible to the external shocks of the 1970s.* (Rodrik, 1999: 96)

For institutional economists, the link between institutions and development is very clear: formal and informal rules define a system of penalties and prizes which determine a set of standardised behavioural patterns. These patterns in turn shape both individual and collective action affecting economic performance and development. Hence, development policies should promote an institutional change i.e. a change in the values and in the rules which inhibit growth, and not only a change of formal rules or the implementation of reforms (i.e. structural adjustment which in social terms may be very costly.

Since "institutions matter", it is important to implement institutional policies. Hence, the question is how to change institutions, how to implement a new institutional deal, which will bring about economic development. Development is defined by sophisticated economists as economic growth and (or plus) institutional change (Toye, 1995). But since institutions are defined by aware institutional economists as social rules or norms, with a set of values on the basis, then to change institutions we need to change those norms and their values. Hence the right definition seems to be: "development as growth through

institutional change" Fadda (2003: 15). In other words a development process is a breaking with previous institutions, routines and norms and the overcoming of "the resistance of established interest and values" that previously impeded economic growth (Kuznets, 1965).

At this point, it is important to underline the connection between Sen's notion of "capability" and a definition of institution, both of which are crucial for economic development. As Fadda (2003:7) puts it: "choices are determined to a large extent by what we want to do, and this is determined by capabilities, as elements of institutions, and capabilities should not be taken as given". Hence, we can re-elaborate the definition of development given above, such as an economic growth through an institutional change with a determinant role of capabilities.

In transition economies, political "…freedom has been accompanied by the loss of many basic economic and social rights" (UNDP,2000:12). This affected negatively people capabilities of doing and being. Consecutively, their economic and social freedom, in Sen's terms of "development as freedom "(1999), worsened because many opportunities disappeared. Hence, today, in the worst performing transition economies (basically all CIS and a few CEECs), people acquired, in the best case, political voice but not freedom in general terms.

In contrast to the Washington Consensus approach, an institutional approach takes into consideration an institutional framework, with its values and informal rule and not only the reformation or the introduction of a limited number of standard institutions. Moreover, this approach does not have a standard and general recipe for development; rather it offers a wider analysis in accordance with which policy makers can implement a number of context dependent policies refered to the particular situation of the country or of the region.

Economic development and institutional economics can be considered two faces of the same coin. Institutional policies and development policies will come

together to make development less uneven and economics more real, and to improve living standards. As Coase (1984) puts it: “In the real world, to influence economic policy we work through institutions. The choice in economic policy is a choice of institutions. And what matters is the effects that a modification in these institutions will actually make in the real world” (Coase, 1984: 1).

Final Remarks

The analysis proposed seems to suggest that, although necessary, macro-economic stabilisation was not a sufficient condition for economic growth. Moreover there is also little evidence so far that growth reduces income poverty. For instance in Poland, which experienced fast growth during the middle of the nineties, income poverty did not fall (Golinowska, 1996). To some extent the same happened in Hungary. On the contrary I found that human development, promoted by institutional policies, seems a sufficient condition for economic growth.

Finally some lessons can be drawn from the transition process so far. The transition towards a new system involves values and systemic change, therefore it needs time proper institutions, and governance ability. CEECs and CIS transition has high social costs. Poverty , which emerged consistently, will not be defeated simply by economic growth. Distribution policies and an institutional approach which help to manage conflicts and to reinforce social cohesion are needed. Human development intended as the widening of people's choices is possible under appropriate institutional policies which give people capabilities of doing and of being: opportunities, access to health, education and the job market. The role of the state in creating such conditions is essential. The state, through its policies, creates the educational system, the health system and income opportunities. Furthermore, institutional policies would allow people to reach opportunities to improve their level of capabilities.

Transition was managed very differently among the various countries, and it yielded different outcomes in terms of growth and development. Institutions made the difference in Poland, Slovenia and to some extent Hungary and the Czech Republic. On the contrary a clear institutional approach was missing in the former Soviet Republics, in Bulgaria and Romania, and in some former Yugoslavian countries which were affected by the war. In particular we can distinguish five groups of countries.

1. Countries which *clearly* increased both their level of HDI and their GDP[24]. They are very few in number (Slovenia, Poland, the Czech Republic and Hungary) and are where, soon or later during nineties, social oriented reforms, income distribution policies, conflict management institutions, social pacts, welfare support, were introduced.
2. Countries which did not increase either their HDI or their GDP level. These are countries where transition never even started. Basically, they still have a planned economy and do not enjoy pluralism and a high level of democracy. They are Uzbekistan, Belarus, and to some extent Turkmenistan.
3. Countries which experienced an increase in income without a correspondent and consistent increase in HDI (i.e. Albania, Latvia, Croatia, Lithuania, Estonia, Slovakia).
4. The majority of countries experienced a reduction of HDI and a reduction of income levels: Russia, Bulgaria, Romania, Moldova, Kyrgyzstan, Ukraine, Kazakhstan, Macedonia (TFRY); plus Bosnia-Herzegovina and Serbia-Montenegro. They are the worst performing transition economies.
5. Few Countries experienced a stable HD level and a reduction of the income: Tajikistan, Georgia, Armenia, and Azerbaijan.

[24] I.e. countries which did not register a negative change in HDI during 1990-2002 and which had a GDP level greater in 2002 than in 1989. See Appendix, table B.

However, as we saw, poverty increased dramatically in all former URSS countries and in some CEECs too. What we did not observe is a clear increase in HDI without an increase in GDP. This is an important empirical result which supports the idea of investing in human development to increase GDP. GDP growth, then, requires human development.

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APPENDIX

Table A. Human Development Index

HDI Rank (World)		**Life expectancy index**	**Education index**	**GDP index 2004**	**Human development index (HDI) value**(**2002)	GDP minus HDI**
High Human Development						
27	Slovenia	0,85	0,96	0,87	0,895	3
32	Czech Republic	0,84	0,92	0,84	0,868	7
36	Estonia	0,78	0,98	0,8	0,853	10
37	Poland	0,81	0,96	0,78	0,85	13
38	Hungary	0,78	0,95	0,82	0,848	3
41	Lithuania	0,79	0,96	0,77	0,842	10
42	Slovakia	0,81	0,91	0,81	0,842	1
48	Croatia	0,82	0,9	0,77	0,83	4
50	Latvia	0,76	0,95	0,75	0,823	6
Medium Human Development						
56	Bulgaria	0,77	0,91	0,71	0,796	10
57	Russian Federation	0,69	0,95	0,74	0,795	3
60	Macedonia, TFYR	0,81	0,87	0,7	0,793	15
62	Belarus	0,75	0,95	0,67	0,79	24
65	Albania	0,81	0,89	0,65	0,781	31
66	Bosnia and Herzegovina	0,82	0,84	0,68	0,781	15
69	Romania	0,76	0,88	0,7	0,778	5
70	Ukraine	0,74	0,94	0,65	0,777	25
78	Kazakhstan	0,69	0,93	0,68	0,766	4
82	Armenia	0,79	0,9	0,57	0,754	33
86	Turkmenistan	0,7	0,93	0,63	0,752	16
91	Azerbaijan	0,78	0,88	0,58	0,746	23
97	Georgia	0,81	0,89	0,52	0,739	29
107	Uzbekistan	0,74	0,91	0,47	0,709	35
110	Kyrgyzstan	0,72	0,92	0,46	0,701	33
113	Moldova, Rep. of	0,73	0,87	0,45	0,681	36
116	Tajikistan	0,73	0,9	0,38	0,671	45

Source: UNDP, Human Development Report 2004

Notes:

** Based on the life expectancy index, education index, and the GDP index;*

*** HDI rank minus GDP per capita (PPP US$) rank. A positive figure indicates that the HDI rank is higher than the GDP per capita (PPP US$) rank, a negative the opposite.*

Table B. HUMAN DEVELOPMENT INDEX TREND

		HUMAN DEVELOPMENT INDEX TREND							Average Gdp_Growth
High human development		1975	1980	1985	1990	1995	2000	2002	1990-2002
27	Slovenia	..	..	..	..	0,852	0,883	0,895	4,2
32	Czech Republic	..	..	..	..	0,843	0,856	0,868	1,4
36	Estonia	..	..	..	0,817	0,796	0,839	0,853	2,3
37	Poland	..	..	..	0,802	0,816	0,843	0,85	4,2
38	Hungary	0,777	0,793	0,807	0,807	0,81	0,837	0,848	2,4
41	Lithuania	..	..	..	0,823	0,789	0,829	0,842	-0,3
42	Slovakia	..	..	..	..	..	..	0,842	2,1
48	Croatia	..	..	..	0,806	0,798	0,823	0,83	2,1
50	Latvia	..	0,795	0,807	0,807	0,765	0,808	0,823	0,2
Medium human development									
56	Bulgaria	..	0,768	0,788	0,795	0,784	0,791	0,796	-2
57	Russian Federation	..	..	..	0,813	0,771	..	0,795	-2,4
60	Macedonia, TFYR	..	..	..	..	..	..	0,793	-0,7
62	Belarus	..	..		0,785	0,752	0,775	0,79	0,2
65	Albania	..	..	0,691	0,702	0,702	0,74	0,781	6
66	Bosnia and Herzegovina	..	..	..	..	..	..	0,781	18
69	Romania	..	..	..	0,771	0,769	0,773	0,778	0,1
70	Ukraine	..	..	..	0,798	0,751	0,762	0,777	-6
78	Kazakhstan	..	..	..	0,767	0,725	0,744	0,766	-0,7
82	Armenia	..	..	..	0,751	0,708	..	0,754	1,7
86	Turkmenistan	..	..	..	..	..	..	0,752	-3,2
91	Azerbaijan	..	..	..	..	..	..	0,746	0,2
97	Georgia	..	..	..	..	..	..	0,739	-3,9
107	Uzbekistan	..	..	..	..	0,687	..	0,709	-0,9
110	Kyrgyzstan	..	..	..	..	..	..	0,701	-3,2
113	Moldova, Rep. of	..	..	..	0,736	0,684	0,673	0,681	-6,9
116	Tajikistan	..	..	0,719	0,719	0,651	0,655	0,671	-8,1

Source: UNDP, Human Development Report 2004.

Last column: Author's elaboration on EBRD data, Transition Report 2003

Notes:

In grey countries which experienced during 1990s a negative change in HDI

Table C. GDP change 1989-2001 (in %)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Estimated level of real GDP in 2000
						(in per cent)								(1989=100)
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.4	3.7	3.8	**80**
Czech Republic	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.8	3.1	3.5	**98**
Estonia	8.1	-6.5	-13.6	-14.2	-8.8	-2.0	4.6	4.0	10.4	5.0	-0.7	6.9	4.5	**83**
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	4.5	**104**
Latvia	6.8	2.9	-10.4	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	6.5	**64**
Lithuania	1.5	-5.0	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.3	5.1	-3.9	3.9	4.0	**65**
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0	2.0	**127**
Slovak Republic	1.4	-2.5	-14.6	-6.5	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2	3.0	**103**
Slovenia [1]	-1.8	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.5	4.6	3.8	5.2	4.6	2.2	**114**
Central eastern Europe and the Baltic states	*0.6*	*-6.6*	*-10.3*	*-2.2*	*0.3*	*3.9*	*5.4*	*4.8*	*4.9*	*3.4*	*2.6*	*4.0*	*2.9*	***107***
Albania	9.8	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-7.0	8.0	7.3	7.8	7.0	**103**
Bosnia and Herzegovina	na	-23.2	-12.1	-30.0	-40.0	-40.0	20.8	86.0	37.0	10.0	10.0	5.0	5.0	**na**
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	5.8	4.0	**71**
FR Yugoslavia	1.3	-7.9	-11.6	-27.9	-30.8	2.5	6.1	7.8	10.1	1.9	-15.7	5.0	5.0	**47**
FYR Macedonia	0.9	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	1.2	1.4	2.9	2.7	5.1	-4.0	**77**
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.6	4.0	**77**
South-eastern Europe	*-2.8*	*-7.3*	*-14.8*	*-9.6*	*-2.4*	*3.0*	*6.2*	*3.2*	*-0.7*	*-0.8*	*-3.2*	*3.6*	*4.0*	***73***
Armenia	14.2	-7.4	-11.7	-41.8	-8.8	5.4	6.9	5.9	3.3	7.2	3.3	6.0	6.0	**63**
Azerbaijan	-4.4	-11.7	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.0	7.4	11.1	8.0	**52**
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	2.5	**85**
Georgia	-4.8	-12.4	-20.6	-44.8	-25.4	-11.4	2.4	10.5	10.8	2.9	3.0	1.9	3.0	**34**
Kazakhstan	-0.4	-0.4	-13.0	-2.9	-9.2	-12.6	-8.2	0.5	1.7	-1.9	2.7	9.6	10.0	**69**
Kyrgyzstan	8.0	3.0	-5.0	-19.0	-16.0	-20.1	-5.4	7.1	9.9	2.1	3.7	5.1	5.0	**66**
Moldova	8.5	-2.4	-17.5	-29.1	-1.2	-31.2	-1.4	-7.8	1.3	-6.5	-4.4	1.9	5.0	**33**
Russia	0.0	-4.0	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.9	-4.9	5.4	8.3	5.5	**63**
Tajikistan	-2.9	-1.6	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	8.3	6.0	**47**
Turkmenistan	-6.9	2.0	-4.7	-5.3	-10.0	-17.3	-7.2	-6.7	-11.3	5.0	16.0	17.6	10.0	**75**
Ukraine	4.0	-3.4	-8.7	-9.9	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.8	7.0	**42**
Uzbekistan	3.7	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.5	4.4	4.1	4.0	3.0	**98**
Commonwealth of Independent States	*0.6*	*-3.7*	*-5.6*	*-13.7*	*-9.3*	*-13.8*	*-5.2*	*-3.5*	*1.0*	*-3.7*	*4.5*	*7.9*	*5.8*	***61***
Central and eastern Europe, the Baltic states and the CIS [1]	**0.3**	**-5.0**	**-7.9**	**-9.1**	**-5.1**	**-6.1**	**-0.4**	**0.1**	**2.2**	**-1.1**	**3.0**	**5.5**	**4.3**	**72**

Source: Transition Report, 2001